

An alternative to the debt snowball

With the turmoil in the stock market, the decline in interest rates on savings, and the resulting instability in the economy, some individuals are considering whether it might be prudent to clean up their personal finances by paying off debt, especially high interest credit card debt. For some, this is simply a matter of transferring money out of a savings account to pay off credit card balances. But for many others, paying down credit card debt involves reallocating monthly income: instead of saving or spending, more of your monthly income will be used for debt reduction. One of the popular strategies for managing this reallocation is sometimes referred to as the “debt snowball.”

The debt snowball is a systematic way to reduce or eliminate personal debt, typically on credit cards. In this strategy, you determine how much additional income you can commit to debt reduction, and allocate the entire amount to one account, while continuing to make minimum payments on the other accounts. For example, suppose you have three credit card accounts with the following balances and minimum monthly payments:

Credit card A: \$5,000 - \$150/mo. minimum payment

Credit card B: \$6,000 - \$120/mo. min. payment

Credit card C: \$3,500 - \$105/mo. min. payment

In total, these three accounts require \$375/mo. to pay the minimum amounts. After examining your budget, you determine you can allocate an *additional* \$225/mo. to paying off these balances. Using the debt snowball strategy, you would apply the entire \$225 to one account. (Which account you choose might depend on several factors, including the interest rate or minimum payment, but most snowball articles recommend tackling the smallest balance first.) For this illustration, let’s choose credit card C to receive the extra \$225, or a total monthly payment of \$330. (*See Fig. 1.*)

In approximately one year, credit card C is paid off. Now the “snowball” effect can begin. Since you no longer have to pay \$330/mo. to credit card C, that amount can be added to credit card A. With card A now receiving monthly payments of \$480 (the \$150/mo. minimum plus the \$330 previously applied to card C), this account is paid off in eight months. All that’s left is credit card B, and your full debt reduction payment of \$600/mo. can be applied to one account. Another six or seven months, card B’s balance is zero – and now you have \$600/mo. to save or spend.

It sounds great, right? But is the debt snowball really the best strategy for debt reduction? Maybe, maybe not. The appeal of the debt snowball is mostly psychological. By concentrating your debt reduction efforts on one account, you have the positive reinforcement of seeing significant progress in reducing one account. And hopefully, that success gives you momentum to stay the course until all accounts are paid. But from a big-picture perspective, \$600/mo. was used to pay off \$14,500 in credit card debt over 2½ years. Although there might be a slight difference in the outcome depending on the interest charged by the various accounts, this result would have been accomplished in the same time period if the extra \$225 had been divided equally (\$75 each) over the three accounts.

The real key to successfully paying off the credit cards is **consistency**, in making the \$600 monthly payment, and also in **not adding additional amounts** to the credit card balances. And really, those are the bigger issues that determine success or failure in clearing the debt. Which is why it might be worth considering a counter-intuitive alternative to the debt snowball: what if you make only the minimum payments and focus on saving more money?

Using the example in *figure 1*, instead of allocating an extra \$225 each month to debt reduction, **deposit the money in a savings account for one year**. This doesn’t immediately help debt reduction, but *saving first* does deliver some other immediate and long-term benefits.

First, the reason many people run up credit card debt is because they don't have cash available. Either they don't budget properly, or they haven't developed the self-discipline to save and pay cash instead of borrowing and paying interest. **One of the long-term keys to controlling debt is establishing the habit of saving.**

Second, if you're using a debt snowball strategy to pay off existing debt, what happens when one of those unexpected expenses comes up? Most likely, the solution means using the credit card again, adding more debt to the pile. But **if you have built up your savings, you may not have to dip into the credit card well.**

Third, having a savings account might give you the assurance that you can continue making minimum payments (and preserve your credit rating) even if your income takes a hit because of smaller bonuses, a layoff, illness, etc.

Finally, having established a better financial framework for the future, lump sums from the savings account can be applied to credit card balances on regular intervals, perhaps every six months or once a year. Similar to the debt snowball, this **minimum-payment-and-save-the-difference approach pays off the credit cards faster than simply making minimum payments.**

At this point, some math-oriented skeptic is likely to point out that the interest that continues to accrue against the higher credit card balance is likely far greater than the interest earned in the savings account. This is true. But how much difference does it really make?

Consider credit card C, the one with the \$3,500 balance. Assume the annual interest charged is 18%. At \$105/mo., it would take 46 months to pay off the account. (see Fig. 1). Adding \$225 each month to the \$105 would pay off the balance in 12 months (Fig. 2), with a final month payment of \$149.22.

FIG. 1 CREDIT CARD C: PAYDOWN WITH MINIMUM PAYMENTS

18.00% Interest

charged

MONTH	BEGINNING BALANCE	MONTHLY PAYMENT	INTEREST CHARGED	ENDING BALANCE	MONTH	BEGINNING BALANCE	MONTHLY PAYMENT	INTEREST CHARGED	ENDING BALANCE
					24	\$2,027.80	\$105.00	\$28.84	\$1,951.64
1	\$3,500.00	\$105.00	\$50.93	\$3,445.93	25	\$1,951.64	\$105.00	\$27.70	\$1,874.34
2	\$3,445.93	\$105.00	\$50.11	\$3,391.04	26	\$1,874.34	\$105.00	\$26.54	\$1,795.88
3	\$3,391.04	\$105.00	\$49.29	\$3,335.33	27	\$1,795.88	\$105.00	\$25.36	\$1,716.25
4	\$3,335.33	\$105.00	\$48.45	\$3,278.78	28	\$1,716.25	\$105.00	\$24.17	\$1,635.41
5	\$3,278.78	\$105.00	\$47.61	\$3,221.39	29	\$1,635.41	\$105.00	\$22.96	\$1,553.37
6	\$3,221.39	\$105.00	\$46.75	\$3,163.14	30	\$1,553.37	\$105.00	\$21.73	\$1,470.10
7	\$3,163.14	\$105.00	\$45.87	\$3,104.01	31	\$1,470.10	\$105.00	\$20.48	\$1,385.57
8	\$3,104.01	\$105.00	\$44.99	\$3,043.99	32	\$1,385.57	\$105.00	\$19.21	\$1,299.78
9	\$3,043.99	\$105.00	\$44.08	\$2,983.08	33	\$1,299.78	\$105.00	\$17.92	\$1,212.70
10	\$2,983.08	\$105.00	\$43.17	\$2,921.25	34	\$1,212.70	\$105.00	\$16.62	\$1,124.32
11	\$2,921.25	\$105.00	\$42.24	\$2,858.49	35	\$1,124.32	\$105.00	\$15.29	\$1,034.61
12	\$2,858.49	\$105.00	\$41.30	\$2,794.80	36	\$1,034.61	\$105.00	\$13.94	\$ 943.55
13	\$2,794.80	\$105.00	\$40.35	\$2,730.14	37	\$ 943.55	\$105.00	\$12.58	\$ 851.13
14	\$2,730.14	\$105.00	\$39.38	\$2,664.52	38	\$ 851.13	\$105.00	\$11.19	\$ 757.32
15	\$2,664.52	\$105.00	\$38.39	\$2,597.91	39	\$ 757.32	\$105.00	\$ 9.78	\$ 662.11
16	\$2,597.91	\$105.00	\$37.39	\$2,530.31	40	\$ 662.11	\$105.00	\$ 8.36	\$ 565.46
17	\$2,530.31	\$105.00	\$36.38	\$2,461.69	41	\$ 565.46	\$105.00	\$ 6.91	\$ 467.37
18	\$2,461.69	\$105.00	\$35.35	\$2,392.04	42	\$ 467.37	\$105.00	\$ 5.44	\$ 367.81
19	\$2,392.04	\$105.00	\$34.31	\$2,321.34	43	\$ 367.81	\$105.00	\$ 3.94	\$ 266.75
20	\$2,321.34	\$105.00	\$33.25	\$2,249.59	44	\$ 266.75	\$105.00	\$ 2.43	\$ 164.17
21	\$2,249.59	\$105.00	\$32.17	\$2,176.76	45	\$ 164.17	\$105.00	\$ 0.89	\$ 60.06
22	\$2,176.76	\$105.00	\$31.08	\$2,102.83	46	\$ 60.06	\$ 60.06	\$ 0.00	\$ 0.00

If the \$225 was deposited each month in a savings account earning 2% (Fig. 3), the accumulation could be applied as a lump-sum payment of \$2,729.43 in the 12th month, with a final payment of \$65.43 in the 13th month to completely clear the credit card account.

Thus, even though the difference between the interest charged by the credit card and interest earned in the savings account is 16%, the difference in payoff time is **only one month!** Even better, with one account paid off, you can "snowball" your savings, now adding \$330 each month to your account, making it possible to pay off the next card sooner while also making it less likely that you will have to use a credit card in the future. On paper, the debt snowball strategy helps you roll down your debt, but snowballing your saving might accomplish the same objective while delivering other important benefits.